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July 30, 2004

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Honorable Pat Miller
Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

**RE: UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY
CORPORATION, INCENTIVE PLAN ACCOUNT AUDIT
Docket 01-000704**

Dear Chairman Miller:

Enclosed is an original and thirteen copies of the Direct Testimony of Steve Brown of the Consumer Advocate and Protection Division of the Office of the Attorney General. Kindly file the attached in this docket. By copy of this letter, we are serving all parties of record. If you have any questions, please feel free to contact me. Thank you

Sincerely,

A handwritten signature in dark ink, appearing to read "T. Phillips", written over a horizontal line.

Timothy C. Phillips
Senior Attorney General
(615) 741-8700

Enclosures

cc: All Parties of Record

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CERTIFICATE OF SERVICE

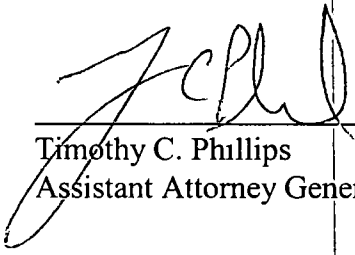
I hereby certify that on July 30, 2004, a true and exact copy of the foregoing document has been sent to the following via method indicated below:

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Timothy C. Phillips
Assistant Attorney General

Before the

TENNESSEE REGULATORY AUTHORITY

**IN RE: UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY
CORPORATION COMPANY, INCENTIVE PLAN ACCOUNT (IPA) AUDIT**

DOCKET NO. 01-00704

**DIRECT TESTIMONY
OF
STEVE BROWN**

July 30, 2004

IN THE TENNESSEE REGULATORY AUTHORITY
NASHVILLE, TENNESSEE

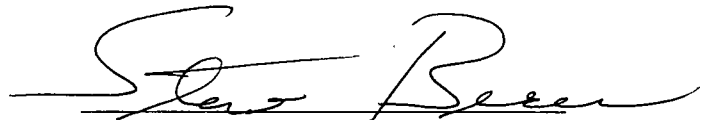
IN RE:

UNITED CITIES GAS COMPANY, a
Division of ATMOS ENERGY
CORPORATION COMPANY,
INCENTIVE PLAN ACCOUNT (IPA)
AUDIT

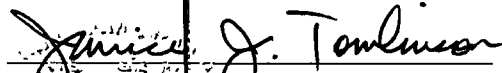
DOCKET NO. 01-00704

AFFIDAVIT

I, Steve Brown, for the Consumer Advocate and Protection Division of the Attorney General's Office, hereby certify that the attached Direct Testimony represents my opinion in the above-referenced case and the opinion of the Consumer Advocate and Protection Division.


STEVE BROWN
Economist

Sworn to and subscribed before me
this 29th day of July, 2004.


NOTARY PUBLIC

My commission expires:

7/21/2007

I. Introduction

Q_1. Please state your name.

A_1. Steve Brown.

Q_2. Where do you work and what is your job title?

A_2. I am an Economist in the Consumer Advocate and Protection Division, Office of the Attorney General.

Q_3. What are your responsibilities as an Economist?

A_3. I review companies' petitions for rate changes and follow the economic conditions that affect the companies.

Q_4. What experience do you have regarding utilities?

A_4. In 1995 I began work as an economist in the Consumer Advocate and Protection Division (CAPD) of the Attorney General's Office. I have also appeared as a witness for CAPD in several cases before the Tennessee Regulatory Authority (TRA). From 1986 to 1995 I was employed by the Iowa Utilities Board as Chief of the Bureau of Energy Efficiency, Auditing and Research,

and Utility Specialist and State Liaison Officer to the U.S. Nuclear Regulatory Commission. From 1984 to 1986 I worked for Houston Lighting & Power as Supervisor of Rate Design. From 1982 to 1984 I worked for Arizona Electric Power Cooperative as a Rate Analyst. From 1979 to 1982 I worked for Tri-State Generation and Transmission Association as Power Requirements Supervisor and Rate Specialist. Since 1979 my work spanned many issues including cost of service studies, rate design issues, telecommunications issues and matters related to the disposal of nuclear waste.

Q_5. What is your educational background?

A_5. I have an M.S. in Regulatory Economics from the University of Wyoming, an M.A. and Ph.D. in International Relations with a specialty in International Economics from the University of Denver, and a B.A. from Colorado State University.

Q_6. Dr. Brown, have you authored any articles relating to your profession?

A_6. Yes, my articles have appeared in Public Utilities Fortnightly.

Q_7. Are you and have you been a member of any professional organizations, Dr. Brown?

1 A_7.

Yes, I am a past member of the NARUC Staff Committee on Management Analysis, a past trustee of and a member of the Board for the Automatic Meter Reading Association, and a current member of the National Association of Business Economists.

8 Q_8.

Have you studied mathematics and statistics as part of your education?

11 A_8.

Yes.

13 Q_9.

Dr. Brown, do you use mathematics and statistics in combination with economics as part of your profession?

17 A_9.

Yes.

19 Q_10.

What were you asked to do in this case?

21 A_10.

I was asked to form opinions on two issues relating to the Performance Based Ratemaking (PBR) program of Atmos (the Company):

1) Whether the TRA's final order of August 16, 1999 in TRA Docket No. 97-01364, "Application Of United Cities Gas To Establish An Experimental Performance-Based Ratemaking Mechanism," directly or implicitly recognized and approved the so-called "FERC Maximum Rate" as a means for calculating the income Atmos receives through the PBR;

2) Whether the PBR should be amended to recognize and approve the so-called "FERC Maximum Rate" as a means for calculating the income Atmos should receive through the PBR.

II. The "Maximum FERC Rate" Is Not A Part Of The PBR And Should Not Be A Part Of The PBR

Q_11. Are you knowledgeable regarding the PBR?

A_11. Yes.

Q_12. What is the basis of your knowledge?

A_12. My knowledge is based on my work with the CAPD. As staff of CAPD I have followed and analyzed the PBR since its inception in March 1995. From that time until now I have testified in every contested case the TRA convened to determine the merit of the PBR and its implementation.

The PBR is prospective by definition in the sense that "performance based ratemaking" operates through carefully determined formulas which are benchmarks representing the current and future state of the market, not the market's historical condition. The TRA determined that such

1 formulas gave the PBR an "automatic"
2 quality to penalize and reward the
3 Company:
4

5 *"The Tennessee Regulatory Authority has the statutory power to*
6 *approve a performance-based incentive mechanism which*
7 *automatically penalizes or rewards the public utility for its*
8 *performance in procuring natural gas that it sells to its*
9 *customers"*[Phase Two Order, page 6]
10

11 *"The proposal was designed to create an incentive to perform*
12 *better than... the market and to penalize the Company [for] ... a*
13 *price of gas above the pre-defined benchmarks."* [Phase Two
14 *Order, page 2]*
15

16
17 Therefore, the risk of penalty or loss is
18 fundamental to the PBR. Nothing in the PBR
19 allows the Company to change, add to, or
20 withdraw the pre-defined benchmarks,
21 otherwise the Company changes the risk-
22 measures in the PBR. The Company cannot
23 unilaterally modify or amend the PBR:
24

25 *"United Cities Gas Company is authorized to operate under the*
26 *[PBR] ... until the mechanism is either (a) terminated at the end of*
27 *Plan year by not less than ninety (90) days notice by United Cities*
28 *to the Authority, or (b) the PBR mechanism is modified, amended,*
29 *or terminated by the Authority."* [Phase Two Order, page 26]
30

Q_13.

In your opinion does the TRA's final order of August 16, 1999 in TRA Docket No. 97-01364 directly or implicitly allow Atmos to use "FERC Maximum Rate" to calculate the income Atmos receives through the PBR?

A_13.

No. In my opinion the final order neither directly nor implicitly allows the Company to use the "FERC Maximum Rate" to calculate the PBR's payments to Atmos. Nowhere in the entire record is there mention of the "FERC Maximum Rate."

Based on the record, my opinion is that the PBR is a substitute for the TRA's enforcement of the requirements of Section 1220-4-7.05 of the TRA's Purchased Gas Adjustment Rules titled "Audit of Prudence of Gas Purchases." My professional opinion as an economist is that the PBR is a "ratemaking." My professional opinion is that the TRA intended to assure that the PBR provides just and reasonable rates by strictly defining the PBR's implementation according to an index where the index is between the minimum and maximum prices of the market, and where the index is the PBR's tool to separate gain from loss. The PBR does not allow the "FERC maximum price" or any maximum price to be a basis for the calculation of the PBR's payments to Atmos.

Therefore, the Company errs when it claims that the "FERC maximum price" is included in the PBR. The "FERC Maximum Rate" has no risk-taking element for Atmos because there is no such thing as a price higher than the maximum price. Use of the "FERC Maximum Rate" contradicts the Authority's clear policy that the incentive program be conditioned by the Company's gains and losses, rather than being conditioned solely by gains.

Q_14.

What evidence in the record indicates the PBR is a ratemaking?

A_14.

The record shows the TRA applying the "just and reasonable" ratemaking standard to the PBR and determining that the prudence reviews should be waived. Chairman Greer cross-examined Atmos witness James Harrington:

"Q. If this plan is denied, how would you suggest that the TRA determine the company's purchasing gas at just and reasonable rates?"

A. Let me just make sure I understand the hypothetical. You're saying there's no incentive plan?"

Q. Yeah.

A. But the Woodward contract exists or doesn't exist?"

1 *Q. Well, if United Cities' plan is denied, how would the TRA*
2 *determine if the company is purchasing gas at just and reasonable*
3 *rates?*

4
5 *A. If you don't employ an incentive program, the other existing*
6 *mechanism is through a prudence review process " [Transcript,*
7 *Friday, March 27, 1998 Volume II, page 517, lines 10-25]*

8
9 Thus, the Authority's Phase Two Order waived
10 prudence reviews of Atmos:

11
12 *"For each plan year in which this Performance-Based*
13 *Ratemaking Mechanism is in effect, the requirements of Section*
14 *1220-4-7.05 of the Purchased Gas Adjustment Rules of*
15 *the Authority entitled 'Audit of Prudence of Gas Purchases are*
16 *hereby waived.' " [Phase Two Order, page 27]*

17
18 In addition, the TRA found in its Phase
19 One Order:

20
21 *"United Cities has the burden to prove that any and all changes in*
22 *rates are just and reasonable under Tenn Code Ann. §65-5-*
23 *203(a) " [Phase One Order, page 29]*

24
25 The testimony of Mr. Frank Creamer, a witness
26 in Docket 97-01364, confirms that the Company's
27 understanding of the PBR is that its terms had
28 to be established before the PBR could be
29 implemented:
30

1 *"But that's the point of the PBR It's to establish a target against*
2 *which the company will be judged next year, the year after, and the*
3 *year after that. So it makes it clear for everybody to understand*
4 *and see how rewards are being earned, how penalties are being*
5 *absorbed, and the standards against which gas purchase*
6 *prudencies will be measured against "* [Transcript, Friday, March
7 *27, 1998 Volume II, page 477, lines 7-14]*
8

9 However, the Company has never established
10 that the "FERC Maximum Rate" is a TRA-
11 approved standard or TRA-measure of "gas
12 purchase prudencies" or that the "FERC
13 Maximum Rate" embodies or facilitates the
14 PBR's establishment of just and reasonable
15 rates.
16

17 Q_15. **In your opinion would the "FERC Maximum**
18 **Rate" provide just and reasonable rates**
19 **through the PBR?**
20

21 A_15. No. In my opinion the "FERC Maximum Rate" would
22 not provide just and reasonable rates through
23 the PBR and therefore be properly included in
24 the PBR. "Just and reasonable rates" are
25 achieved in the PBR through risk-taking by the
26 Company, where risk is defined by a market
27 index between the market's maximum and minimum
28 prices, exactly as the TRA staff judged in
29 Docket 97-01364:
30

1 *"A. I see your question. United Cities, prior to the adoption of the*
2 *incentive plan, was actually able to, quote, beat the market,*
3 *unquote. For every winner in the market there must be a loser.*
4 *That's the whole idea of the market index, that it comes back to an*
5 *average price that everyone is paying." [Deposition of William H.*
6 *Novak, Monday, March 23, 1998, page 91 lines 12-13]*

7
8 Staff's opinion on this point is similar to the
9 opinion of the Company's witness, Mr. James
10 Harrington:

11
12 *"For an index price to be an accurate measure of the market*
13 *price, some purchases will be above the index and some will be*
14 *below." [Direct Testimony of James Harrington, page 24 lines 1-2,*
15 *Docket 97-01364]*

16
17
18 The "FERC Maximum Rate" does not expose Atmos
19 to penalty, risk, and the "potential-of-loss"
20 because Atmos can never make purchases above
21 the maximum rate. Therefore, no maximum rate
22 can be a part of the PBR, which can be properly
23 implemented only through an index, as Mr.
24 Harrington describes, or an average, as Mr.
25 Novak describes.

26
27 Q_16.

28 **In your opinion, is the "potential-for-**
29 **loss" or penalty a core principle of the**
30 **PBR?**

31 A_16.

32 Yes. In my opinion, penalty or the
33 "potential-for-loss," is a core principle
34 of the PBR because the Authority's clear
 policy is that the incentive program be

1 measured by the Company's gains and
2 losses, rather than being measured solely
3 by the Company's gains.
4

5 Consider the Authority's orders in Docket 97-
6 01364:
7

8 *"The proposal [PBR] was designed to create an incentive for*
9 *United Cities to perform better than the market and to penalize the*
10 *Company if its acquisition of gas supplies resulted in a price of gas*
11 *above the pre-defined benchmarks " [Phase Two Order, pages 1-*
12 *2]*
13

14 *"The Tennessee Regulatory Authority has the statutory power to*
15 *approve a performance-based incentive mechanism which*
16 *automatically penalizes or rewards the public utility for its*
17 *performance in procuring natural gas that it sells to its*
18 *customers "[Phase Two Order, page 6]*
19

20 *"The gains and losses under the plan should be calculated on a*
21 *monthly basis rather than on a transaction basis "[Phase One*
22 *Order, page 29]*
23

24 *". the gains and losses to be derived from the mechanism are to*
25 *be accounted for " [Phase Two Order, page 28].*
26

27 Mr. Harrington testified that the PBR:
28

29 *"will provide United Cities with an incentive to buy below*
30 *prevailing market price and will penalize if its purchases exceed*
31 *the market price " [Direct Testimony of James Harrington, page*
32 *20 lines 3-8, Docket 97-01364]*
33

1 Mr. Harrington's emphasis on penalty was echoed
2 by the opinion of Mr. Senter, the Company's
3 policy witness. He testified that penalties
4 were necessarily an integral part of the PBR:
5

6 *"If we can save our customers money on the cost of gas, we will*
7 *be rewarded; if we fail, we will be penalized. Either way, the*
8 *company should be rewarded or penalized based upon its*
9 *performance "* [Transcript, Tuesday, March 31, 1998 Volume III,
10 *page 574, lines 2 -6]*
11

12
13 Mr. Creamer further confirms that risk-taking
14 is a central feature of the incentive plan. In
15 cross-examination by the Consumer Advocate Mr.
16 Creamer testified:
17

18 *"The intent of the incentive program is to provide rewards to*
19 *encourage the company to take greater risk in purchasing gas*
20 *leading to benefits "* [Transcript, Thursday, March 26, 1998
21 *Volume I, page 76, lines 3-6].*
22

23 And
24

25 *"So what I observed in interviewing United Cities Gas is, tell me*
26 *what you're doing differently in terms of behaviors, not process,*
27 *but in terms of behaviors in how you're looking at buying gas. Are*
28 *you taking more risk? Are you looking to, in one case, incur a*
29 *higher-than-index price for gas in order to earn a benefit in a*
30 *lower-than-index purchase of gas a week later or two weeks later?*
31 *That's what we're trying to get at in terms of an incentive*
32 *program "*
33

34 *"Q And so, you say they're taking more risks?*

1
2 *A Yes." [Transcript, Thursday, March 26, 1998 Volume I, page*
3 *77, lines 16-25 and page 78, lines 8-9].*
4

5 In redirect examination by Atmos Mr. Creamer
6 was asked and testified about the built-in
7 penalty aspect of the PBR:
8

9 *"Q. Mr. Williams also asked you some questions about basis*
10 *points and rate of return on equity and what the staff*
11 *recommended in that case. You understand that the way this plan*
12 *works is if United Cities does not do a very good job of purchasing*
13 *gas that it can incur a penalty and the result of that penalty would*
14 *essence be a lowering of their authorized rate of return?"*
15

16 *"A The penalty would be a lowering of their rate of return?"*
17

18 *"Q. Yes Based upon the answer that you gave to Mr. Williams*
19 *about the fact that if they were awarded, that, in essence, would*
20 *increase their rate of return?"*
21

22 *"A. Would increase their overall return -- or decrease their*
23 *overall return, what you said. But there would be no Commission*
24 *action that would penalize them. The plan itself would take care of*
25 *that.*
26

27 *"Q It's an automatic penalty?"*
28

29 *"A Yes " [Transcript, Thursday, March 26, 1998 Volume I, page*
30 *285, lines 6-25 and page 286, line 1]"*
31

1 However, there is no possibility of the TRA
2 automatically penalizing Atmos with a lower
3 rate of return if the "FERC Maximum Rate" were
4 incorporated into the PBR.

5
6 Q_17.

**In its proposed Transportation Index
Factor (TIF), how is the Company using and
justifying the "FERC Maximum Rate" to
calculate the PBR's payments to Atmos?**

7
8
9
10
11 A_17.

The Company's method of calculation and
the justification for the method are
clearly stated in Mr. Mark Thessin's
affidavit of October 21, 2002. According
to Mr. Thessin, the PBR defined
transportation-contract-savings as the
difference between the "FERC Maximum Rate"
for transportation and the actual
transportation rate the Company pays.

12
13
14
15
16
17
18
19
20
21 For example, in his affidavit at paragraph
22 10 Mr. Thessin says:

23
24 " UCG had successfully negotiated discounted rates for a
25 substantial portion of its transportation contracts. In prior years
26 UCG's transportation contracts were priced at the maximum rate
27 permitted by [the FERC]. . the savings from those discounted
28 transportation contracts . totaled \$1,160,050 ."
29

1 The Company's claim that it should be
2 rewarded solely on the basis of past
3 performance in comparison to current
4 performance completely contradicts the
5 testimony of its witness, Mr. Harrington,
6 who rejected past performance as measure:
7

8 *"But UCG's past performance was not the market price then and is*
9 *not the market price now "* [Transcript, Friday, March 27, 1998
10 *Volume II, page 512, lines 6-7]*
11

12 At Paragraph 13 Mr. Thessin says further:
13

14 *"UCG explained that the transportation discounts would be*
15 *considered 'avoided transportation costs' under the PBR UCG*
16 *would be entitled to share in those savings "*
17

18 However, the Company has misinterpreted
19 the PBR's meaning of "avoided
20 transportation costs." The PBR's intent is
21 to remove the effects of the
22 transportation price from the gas
23 commodity price, so that gas commodity
24 prices from different parts of the country
25 can be compared to the commodity market
26 indices. The PBR was never intended to be
27 implemented as the Company has done so.
28

29 For example, the TRA staff in its "Compliance
30 Audit Report of United Cities Gas Company's
31 Incentive Plan Account" of April 10, 2002,
32 rejects the Company's use of the "FERC Maximum
33 Rate" in the PBR. The Company's response shows
34 it abandoning the PBR's market indices:

1
2
3 *"The absence of published benchmarks providing comparative*
4 *analysis on discounted transportation rates should not preclude*
5 *the Staff from including transportation discounts in the PBR*
6 *mechanism "* [Compliance Audit Report of United Cities Gas
7 *Company's Incentive Plan Account, Docket No. 01-00704, April*
8 *10, 2002, page 13-14]*

9 Thus the Company is evading the risk-taking
10 measurement embodied in the PBR's use of the
11 widely published market indices. They provide a
12 measure of purchasing activity in comparison to
13 a real market. The "FERC Maximum Rate" bypasses
14 the essential measures described by Mr.
15 Harrington:

16
17 *"Inside F.E.R.C.'s Gas Market reports has been reporting in the*
18 *same format since March 1986. The survey sample comprises more*
19 *than 350 sources [CAPD Emphasis] The sample is composed*
20 *almost entirely of large and small gas producers, pipeline-*
21 *affiliated and non-affiliated marketers, distributors and end-users.*
22 *Prices are reported for actual spot-gas sales agreements, not*
23 *offers or bids "*

24
25 *"Intelligence Press, Inc , publishers of Natural Gas Intelligence*
26 *("NGI") gathers the data used in settling prices via a daily*
27 *telephone survey of industry representatives. The source base*
28 *consists of over three hundred participants [CAPD Emphasis] from*
29 *all sectors of the natural gas industry and its customers. By*
30 *obtaining quotes from a large sampling of producers, marketers,*
31 *intrastate pipelines, industrial end-users, and utilities, NGI*
32 *increases the likelihood that the prices appearing in the newsletter*
33 *more closely approach the true population average in an objective*
34 *manner "*

1
2 *"The NYMEX gas futures index is a major source for discovering*
3 *the US gas reference price. Market participation by a broad*
4 *spectrum of the energy industry [CAPD emphasis] helps ensure*
5 *that all available information on supply and demand is*
6 *incorporated in the price determination process. Gas futures*
7 *prices are determined by free competition among traders who*
8 *announce, by open outcry, their desire to buy or sell a certain*
9 *number of contracts at a certain price The forces of many pricing*
10 *factors ensure that futures prices reflect the true market value of*
11 *the underlying gas commodity and are transparent to the*
12 *marketplace at large."*

13
14 *"Pasha Publications, Inc. publishers of Gas Daily surveys scores*
15 *of respondents per day and a few hundred during bid week*
16 *[CAPD emphasis] to produce ranges and indices. Gas Daily*
17 *surveys the complete spectrum of the industry, from wellhead to*
18 *burnertip, to acquire data. The Gas Daily price team talks to*
19 *major producers and all sizes of independents and marketers from*
20 *the largest national players to the smallest niche players and local*
21 *distribution companies, regardless of size, power companies,*
22 *congenerators and end-users " [Direct Testimony of James*
23 *Harrington, pages 21-22]*

24
25
26 That the Company wants to jettison these
27 indices and be judged by its own historical
28 performance is a sure sign that the "FERC
29 Maximum Rate" is not a part of the PBR and that
30 such a rate should not be a part of the PBR.
31 This concludes my testimony at this time.
32
33